Testimony of
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Federal Energy Regulatory Commission

Before the
Committee on Governmental Affairs
United States Senate

June 20, 2001

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to appear before you today to discuss the role of the Federal Energy Regulatory Commission regarding the restructuring of California's electricity market and its implications for other states and regions. Since the issuance of Order Nos. 888 and 889 on April 24, 1996, the Commission has focused its attention on opening the bulk power market to competition. This effort was prompted, in part, by Congress's enactment of the Energy Policy Act of 1992. The Commission's main objective has been to employ market-oriented solutions to the problems facing the wholesale electricity sector in order to achieve the best long-term results for the public. While the situation in California and the West has certainly challenged this resolve, I remain steadfast in my commitment to ensure that consumers benefit from well-functioning electricity markets.

The magnitude of the California energy crisis, and its potential disruptive effect, cannot be overestimated. The extraordinarily high prices for electricity and the extreme shortages of supply have created a consumer backlash against the restructured electricity markets in California. Nationwide, the move toward competitive markets is undoubtedly affected by this crisis and could even be suspended if other states, fearful of what they are seeing in the West, terminate their restructuring efforts. I believe it is important for all Americans to understand what is happening. That is why I welcome the interest and involvement of the Committee in this matter and I look forward to working with you to address these problems.

It goes without saying that the flawed electricity markets that exist in California today are not at all what proponents of electric restructuring had in mind when this process was initiated both at the federal and state levels six to eight years ago. Nevertheless, consumers and elected officials are unlikely to have continued tolerance for inefficient and problematic markets if they are allowed to persist. For this reason, I believe it is imperative for regulators to take firm steps to improve the markets so that the present turmoil will not cause us to abandon or retreat from the objective of opening the transmission system to fair and non-discriminatory access and making the wholesale electricity markets more competitive. How we proceed over the next year or so will, in large part, determine whether our goals will be met.

It is important to understand that the causes of the California energy crisis are highly complex. I believe there is a danger of oversimplifying the problems by attributing them to the bare fact that California restructured its retail electricity markets. Restructuring programs have taken on many forms and have been implemented under many different circumstances. In retrospect, it is clear that California's restructuring plan embodied features that other states can and should avoid. In addition, a confluence of factors outside of the state's regulatory regime have created problems that are unique to California’s situation. For this reason, it is highly unlikely that other regions of the country will experience this identical set of circumstances. However, some of the problems we see in the West could materialize in other regions. The Commission has focused much of its attention over the past year in defining and understanding the causes of the market disruptions and high electricity prices in California and throughout the West and implementing appropriate remedies, which are beginning to work.

A Commission staff report completed on November 1, 2000 found that: (1) market forces in the form of significantly increased power production costs combined with increased demand due to unusually high temperatures to create unstable conditions in the West; (2) scarcity of available generation resources throughout the Western region played a significant role; (3) existing market rules worsened the tight supply-demand conditions by exposing the three investor-owned utilities in California to the volatility of the spot energy market without affording them the opportunity to mitigate volatility by hedging their positions in forward electricity markets; (4) an underscheduling of demand and supply in the California Power Exchange's (PX) day-ahead and hour-ahead markets increased the activity in the more volatile real-time spot market operated by the California Independent System Operator (ISO); and (5) unplanned outages of power plants increased significantly during the summer of 2000.

It has also become apparent that the causes of the California energy crisis are not only state-specific, but regional in nature. For that reason, we are now engaged in a broad examination of all bulk power markets throughout the Western United States. Furthermore, as I discuss in more detail below, I continue to believe that an important factor in resolving the problems in the electric power market in California and the West is the need to address the impediments in the natural gas market.

I believe the Commission has taken bold and decisive actions, within its jurisdiction, to remedy the extreme distortions in the California markets and to address instances of potential market power abuses. Since last August, the Commission has issued over 50 orders implementing important remedial measures and price mitigation mechanisms, instituting investigations into rates and market design flaws, establishing programs to maximize electricity supply, delivery and demand reduction, and directing sellers to provide refunds of excess amounts charged for certain electric energy sales. Several of the major orders issued by the Commission over the past year deserve to be highlighted.

On August 23, 2000, citing serious concerns about the impact of significant increases in electric rates on residents and businesses in the San Diego area, the Commission instituted an investigation pursuant to Section 206 of the Federal Power Act into the justness and reasonableness of the rates and charges of public utilities that sell energy and ancillary services to or through the ISO and PX. The investigation also sought to uncover whether the institutional structures and bylaws of the ISO and PX were adversely affecting the efficient operation of competitive wholesale electric markets in California.

On November 1, 2000, the Commission issued an order proposing measures to remedy the problems that were identified in the California electricity markets. Our order found that electric market structure and market rules for wholesale sales of electric energy in California were seriously flawed and that these structures and rules, in conjunction with an imbalance of supply and demand in California, have caused, and continue to have the potential to cause, unjust and unreasonable rates for short-term energy under certain conditions. The order proposed specific remedies that were intended to correct the market flaws, including an over-reliance on spot markets in California. The Commission proposed, among other things, to (1) eliminate the requirement that the investor-owned utilities must buy and sell power through the PX; (2) require load serving entities to schedule 95 percent of their transactions in the Day-Ahead markets or be subjected to a penalty charge; and (3) to replace the existing PX and ISO stakeholder boards with independent non-stakeholder boards. To ensure fair prices while market reforms were being put in place, the order proposed specific measures to mitigate high prices. The proposed mitigation plan included a modification of the single price auction so that bids above $150/MWh could not set the market clearing price that is paid to all bidders and imposing certain reporting and monitoring requirements for transactions and bids above the $150/MWh breakpoint, as well as retaining a refund obligation for sales into the ISO and PX markets for the period October 2000 through December 2002. The November 1, 2000 order initiated an expedited hearing process that included dates for the submission of comments and supporting evidence by parties and for a public conference, with the intent of issuing a final order before the end of the year 2000.

On December 15, 2000, the Commission issued its final order implementing a market mitigation and monitoring plan for California as a result of the expedited hearing process initiated in November 1, 2000. For the most part, the elements of the final plan mirror those proposed on November 1, and include: (1) the elimination of the mandatory PX buy-sell requirement; (2) a benchmark price for wholesale bilateral contracts; (3) penalties for underscheduling load in forward markets; (4) a price mitigation plan that included the $150/MWh breakpoint mechanism as an interim measure; (5) an independent governing board for the ISO; and (6) a requirement that the ISO and investor-owned utilities file generation interconnection procedures. Our December 15, 2000 order stated that the interim $150/MWh breakpoint mechanism would be replaced on or before May 1, 2001 by a real-time, forward-looking price mitigation plan.

On March 9, 2001, the Commission issued an order establishing, among other things, a just and reasonable rate screen above which sellers will be required to provide refunds of excess amounts charged for certain electricity energy. The Commission developed this screen by, in effect, establishing the market clearing price that would have occurred had the sellers bid their variable costs into a single price auction, which is what would have occurred had there been competitive forces at work. Using this methodology, the Commission has determined that, during the period January through April 2001, potential refunds by sellers totaled over $124 million.

On March 14, 2001, the Commission issued an order announcing certain actions it was taking within its regulatory authority to help increase electric generation supply and delivery in the Western United States, to facilitate demand responsiveness, and to protect consumers from supply disruptions. The Commission implemented some measures immediately and sought comment on other proposed measures that might help maximize supply, delivery, and demand reduction. Among the actions the Commission took immediately were to request a list of grid enhancements that could be undertaken in the short term, extend certain waivers for Qualifying Facilities, waive certain notice and filing requirements for wholesale power sales from on-site generation at businesses, authorize the resale of load reductions at market-based rates, and request hydroelectric licensees to examine their projects for efficiency improvements. Among the proposals on which the Commission sought comment were allowing premiums on equity returns and accelerated depreciation for certain transmission investments, allowing revenue recovery for non-capital intensive expenditures that increase transmission capacity, allowing the roll-in of certain interconnection costs for new supply, using the interconnection authority of Section 210(d) of the Federal Power Act, waiving blanket certificate regulations to increase the dollar limits for automatic and prior-notice authorizations for natural gas facilities, offering blanket certificates for portable compressor stations, and allowing greater operating flexibility at hydroelectric projects.

Pursuant to the March 14 order, the Commission convened staff conferences in Portland, Oregon and Sacramento, California, to discuss methods for allowing increased generation at hydroelectric projects while ensuring environmental protection. On April 10, 2001, the Commission held a conference on Western Energy Issues in Boise, Idaho to discuss price volatility and other Commission-related issues with state commissioners and others from Western states. All FERC Commissioners attended, as did representatives from Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington and Wyoming.

As a follow-up to our March 14, 2001 order, on May 16, 2001, the Commission issued a further order on supply and demand issues. The Commission reaffirmed actions implemented by the March 14 order, and implemented many of the additional actions identified in that order, including allowing premiums on equity returns and accelerated depreciation for projects that increase electric energy transmission capacity in the short term, with a baseline cost of equity of 11.5 percent.

On April 26, 2001, the Commission issued a major order establishing remedies and market mitigation programs for the California and Western markets that were targeted to specific causes of the California energy crisis. These remedies replace the interim mitigation plan implemented by the December 15, 2000 order. The fundamental principles of this plan are to: (1) enhance the ISO's ability to coordinate and control planned outages in the real-time market during all hours; (2) require sellers with Purchased Generator Agreements, as well as non-public utility generators located in California that make sales through the ISO's markets or that use the ISO's interstate transmission grid, to offer all their available power in real time during all hours; (3) require public utility load serving entities to submit demand-bids identifying the price at which load will be curtailed in the real-time market during all hours; (4) establish conditions, including refund liability, on public utility sellers' market-based rate authority to prevent anticompetitive bidding behavior in the real-time market during all hours; (5) require the ISO to submit weekly reports on schedule, outage, and bid data for all hours so that the Commission can continue to monitor generating unit outages and real-time prices; and (6) establish a mechanism for price mitigation for sellers bidding into the ISO's real-time market during a reserve deficiency that includes a proxy formula for determining the real-time market clearing price when mitigation applies. It is important to note that our April 26 order also initiated a Federal Power Act Section 206 investigation into the rates, terms and conditions of public utility sales for resale of electric energy in interstate commerce in the Western Systems Coordinating Council (WSCC). This investigation is currently underway.

We have seen significant reductions in electric power costs since our April 26 order was implemented on May 29. The daily prices for spot market sales to California on May 23 ranged from $381/MWh to $419/MWh. The daily spot prices after the mitigation plan took effect have trended much lower. On June 6, for instance, the spot prices ranged from $62/MWh to $90/MWh.

As we continue to monitor the situation in the West, the Commission will examine its role in these matters and take appropriate action when necessary. One important aspect of the electricity system in the West and elsewhere in the country, in which I believe the Commission's jurisdictional authority should be increased, pertains to the siting of new transmission facilities. While I wholeheartedly encourage conservation and embrace demand reduction mechanisms, Americans need to understand that due to obsolescence, shifts in regional usage patterns, and continued growth in consumer demand, the country's energy infrastructure must be expanded.

Currently, under the Federal Power Act, the Commission has no role in the permitting and siting of these new facilities. I believe FERC needs to have siting authority for interstate transmission facilities because shortages of transmission are no longer just single state issues. I believe these shortages have become interstate commerce issues that must be addressed by the Federal government. I do believe, however, that siting authority for new generating and distribution facilities should remain at the state level.

While energy prices have dropped recently, we must understand that the problems are caused not only by market design flaws, but also by the lack of adequate supply and delivery capability. In addition, we need a diverse generation mix that includes renewable energy resources. We must continue to develop the infrastructure necessary to meet the growing demands our society places on the electric grid. This will require difficult decisions on siting. If such decisions are avoided or delayed, I am afraid the problems we have seen in California and the West will be magnified and experienced throughout the country.

With regard to transmission upgrades and expansion, I believe the Commission's Order No. 2000, issued in December 1999, will create an important regulatory framework. Order No. 2000 is intended to encourage the formation of Regional Transmission Organizations throughout the United States. The order includes a specific functional requirement for RTOs to develop a strategy for transmission planning and expansion. The order also describes innovative pricing options that the Commission would consider for RTOs. Such ratemaking mechanisms could provide necessary incentives for the construction of new or enhanced transmission facilities. I believe the formation of RTOs in the West will be a significant benefit for many aspects of the electric markets in that region, including the enhancement of the transmission grid.

The Commission also has implemented some specific demand response programs that are within our jurisdiction. As we have noted in recent orders, dropping even a few megawatts off the electric system at peak periods is more efficient and economical than the incremental cost of generating them. The Commission has recognized that these so-called "negawatts" or demand reductions offer a short-term and cost-effective means to provide additional resources during times of scarcity. We have recently instituted programs allowing electric consumers—both retail and wholesale—to reduce their own consumption of electricity for the purposes of reselling their load reduction at wholesale using market-based rates. Demand response programs recognize that customers should be able to respond to price signals and that customers with more elastic demands can relinquish load to customers who place a greater value on obtaining power at that particular time.

Due to the continuing convergence of the electric and natural gas industries, problems that have affected the electric utilities in California and the West also have been felt in the natural gas industry. And while much has been said about the difficulties facing the electric markets in California and the West, I believe that much more attention should be focused on the natural gas issues facing this region. I have a deep concern about the impact of prolonged periods of high natural gas prices on industries and communities in the West, particularly on electric generation costs. The price of natural gas is the variable that has the greatest ability to influence the cost of gas-fired electric generation. This is true even for more efficient electric generation plants. For example, when gas costs were $2 per Mcf, the cost of generation at a plant with a 10,000 Btu/kWh heat rate was $20 per megawatt-hour. When natural gas prices surged to $50 per Mcf, the cost of generation soared to five hundred dollars $500 per megawatt-hour. My point is that the sustained high prices of natural gas contribute to high electricity prices in California and the West.

As with the electric markets, the problems facing the natural gas markets in California are multi-faceted, complex and interrelated. I have serious concerns about: (1) the need for more interstate natural gas pipeline capacity to California; (2) the need for more intrastate natural gas pipeline capacity from the California border to the markets (more “take-away” capacity); (3) policies that create an incentive for the utilities in California to rely too heavily on spot market purchases of natural gas; (4) excessively low working gas storage inventories; (5) the lack of firm capacity rights on intrastate natural gas systems in California; (6) the appropriateness of continuing the waiver of the price-cap on short-term secondary market transactions; and, most importantly, (7) allegations of the exercise of market power by interstate pipelines, affiliate preference, and the withholding of interstate pipeline capacity. While I recognize that some of these matters are not within the Commission’s jurisdiction, I believe they are all relevant to the objective of stable natural gas prices in California.

I would like to point out, with respect to pipeline infrastructure needs, that simply expediting the certification and construction of additional interstate pipeline capacity to California will not be an adequate solution. Without adequate intrastate take-away capacity at the California border, recent actions by the Commission to approve additional interstate pipeline capacity on an expedited basis may not have the desired effect of increasing natural gas supplies in the California markets where they are needed. Indeed, uncoordinated interstate pipeline expansions could serve to exacerbate congestion that exists at the California border. At my urging, the Commission held a technical conference on May 24, 2001, to analyze California natural gas infrastructure needs. This conference identified both physical constraints and regulatory impediments to natural gas transportation into and within California. Comments on the issues raised at the conference are due June 25, 2001.

With regard to the reliance on the spot market for purchases of natural gas, it is my understanding that the California Public Utilities Commission (CPUC) allows for recovery of gas costs that meet a benchmark determined monthly by the use of average spot market prices. It is my opinion that such a policy creates an incentive to rely too much on spot market purchases of natural gas, thereby exposing consumers to more volatile gas prices. I believe that local distribution customers (LDCs) and other gas purchasers in California and other states should have the ability to use appropriate risk management tools. The Commission's December 15, 2000 order on remedies for California found that a major cause of the high electric prices in California was the over-reliance on the spot market for electricity. I believe the same logic applies to the natural gas market.

The low working-gas storage inventories and the lack of firm capacity rights for non-core customers (such as electric generators) on intrastate pipeline systems are issues that I urge the CPUC to address, as they appear to be serious impediments to competitive natural gas markets in California. FERC requires interstate pipeline systems to offer firm open-access transportation and storage services on their systems. If electric generators and other non-core large users of natural gas had firm rights on the intrastate pipeline system, they would be able to acquire available firm capacity on interstate systems moving to California and negotiate reasonable prices from the producers or marketers supplying natural gas. This is the basic objective of any open-access program. It is my understanding that the CPUC has proceedings before it at this time which could result in the creation of firm tradeable intrastate rights, and I look forward to seeing a resolution to this issue.

Another issue that I believe FERC must address is whether to reimpose the maximum rate ceiling on short-term capacity releases into California. On May 22, 2001, we issued an order on a request for relief filed by several parties. The request is based on the assumption that high prices of natural gas delivered at the California border are due, in part, to the ability of persons selling to the California market to charge above the interstate pipeline's maximum tariff rate for the release of pipeline capacity. The May 22 order sought comment on whether the price cap should be reimposed in California, and whether it should be extended to pipelines delivering into the WSCC region. I had reservations about the release of the price cap in FERC Order No. 637, and I therefore advocated strongly to release the price cap as an experiment, with a September 30, 2002 sunset date. This is the approach we took. I now believe that suspension of this experiment may be appropriate in an environment of highly volatile prices.

Finally, it is important to note the allegations of abuse of market power, affiliate preference and withholding of capacity on the part of El Paso Pipeline Company and its affiliate, El Paso Merchant Energy Company. The CPUC maintains that an El Paso Merchant contract, which accounts for approximately one-third of its affiliate's capacity into California, allowed El Paso Merchant to exercise market power and artificially drive up the price of natural gas transported to California. On March 28, 2001, FERC set the issues of market power and withholding for hearing. Subsequently, on June 11, 2001, we expanded the scope of the hearing to include the issue of affiliate preference. The importance of this case can not be overstated, not only for the dollars involved, but also for the Commission to get a better understanding of the events and causes of the significant increase in natural gas prices over the past year.

In conclusion, I am confident that the Commission has taken the appropriate actions at the appropriate time to address the market distortions in California. Our actions have built upon the market-oriented approach that this Commission has been committed to for nearly a decade. In addition, our remedies have been designed not only to help alleviate the extreme high prices borne by Californians and others in the West, but also to ensure that sellers continue to have incentives to sell into the western states and to build sorely needed new generation and transmission necessary to provide reliable service in the future. I have been pleased by the early results of our mitigation efforts. However, I am committed to continue to take all reasonable and appropriate actions required to ensure that these electricity and natural gas markets are operating in an efficient and fair manner and produce prices that are just and reasonable. That has been my goal all along and it continues to be what guides me every day at the Commission.